

Letter of Findings: 07-0481
Sales and Use Tax
For the Years 2004, 2005, 2006

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ISSUES

I. Use Tax – Agricultural Production Exemption.

Authority: IC § 6-2.5-2-1; IC § 6-2.5-3-2; IC § 6-2.5-3-4; IC § 6-2.5-5-1; IC § 6-2.5-5-2; IC § 6-8.1-5-1; [45 IAC 2.2-5-1](#); [45 IAC 2.2-5-3](#); [45 IAC 2.2-5-4](#); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289 (Ind. Tax Ct. 2007); *Indianapolis Fruit Co. v. Dept. of State Revenue*, 691 N.E.2d 1379 (Ind. Tax Ct. 1998); *Graham Creek Farms v. Ind. Dep't of State Revenue*, 819 N.E.2d 151 (Ind. Tax Ct. 2004).

Taxpayer protests the imposition of use tax on hoop buildings it uses on its farm.

II. Tax Administration – Imposition of Negligence Penalty.

Authority: IC § 6-8.1-10-2.1, [45 IAC 15-11-2](#).

Taxpayer protests the assessment of negligence penalty.

STATEMENT OF FACTS

Taxpayer operates a farm that produces crops, hay, straw, and other related commodities. The Department conducted a sales and use tax audit of Taxpayer's business and assessed additional sales and use tax. Taxpayer agreed with some of the additional assessments, but protested the assessment of use tax on hoop buildings used to store hay. The hoop buildings were leased from an out of state location and picked up by Taxpayer.

The hoop buildings consist of a hoop (or arch) roof that rest on a wood frame structure. The hoop roof comprises approximately two-thirds of the height of the buildings. The buildings have a wide and long free span. The buildings are open at each end. The sides are enclosed but the roof is tarped on top of and inside the buildings. Some of the buildings have rafters that run alongside the length of building.

According to industry materials, these structures are typically used for equipment storage, hay and crop storage, and as livestock shelters. In Taxpayer's case the buildings help prevent degradation of the hay by shielding it from sun, wind, rain, and snow. Also, the clear span of the buildings allows for unobstructed airflow that reduces the formation of mold and mildew. The tarped roof is unique to this type of building.

At the hearing Taxpayer's representative stated that Taxpayer produces approximately thirty-two thousand square bales of hay and six-thousand round bales. Taxpayer does not sell all of its hay at once, so it must keep the bales on its premises. Since hay is subject to spontaneous combustion, it requires special storage. The hoop buildings are well-drained with fans hung at both ends of the building to help ventilate the building. Hay is placed both on the rafters and also on pallets that sit on gravel and lime. Lime pulls water away from the hay and the gravel helps drain the water.

A hearing was held on Taxpayer's protest where Taxpayer was represented by its accountant. The hearing was held open to allow Taxpayer additional time to support its protest. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Use Tax – Agricultural Production Exemption.

DISCUSSION

On initial review, the Department found that Taxpayer had purchased hoop buildings without paying sales tax at the time of purchase, and assessed use tax on the purchase.

Taxpayer contends that Taxpayer's use of the hoop buildings qualified for an exemption from use tax, therefore, Taxpayer did not pay the sales tax at the time of purchase. Taxpayer argues that the hoop buildings are an essential part of the integrated production process of hay. Taxpayer states that "a normal barn structure would burn down, and has in the past." Furthermore, Taxpayer states that without the hoop buildings its production would decrease and mold would cause loss of crop due to the lack of ventilation, and fire would be a hazard.

All tax assessments are prima facie evidence that the Department's claim for the tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes a sales tax on retail transactions and a complementary use tax on tangible personal property that is stored, used, or consumed in the state. IC § 6-2.5-2-1. An exemption from the use tax is granted for transactions where the gross retail tax ("sales tax") was paid at the time of purchase pursuant to IC § 6-2.5-3-4. Furthermore, IC § 6-2.5-5-1 and IC § 6-2.5-5-2 exempt tangible personal property used in agricultural production. Both of these exemptions require a taxpayer to be engaged in production. The fact that an item is purchased for use on a farm does not necessarily make it exempt. [45 IAC 2.2-5-4\(e\)](#). A taxpayer must also show how the tangible personal property for which it seeks an exemption is *directly* used in its production process. IC §

6-2.5-5-1(a); *Indianapolis Fruit Co. v. Indiana Dep't of State Revenue*, 691 N.E.2d 1379, 1383 (Ind. Tax Ct. 1998). In other words, the tangible personal property for which Taxpayer seeks exemption must be integral and essential to its production process, a determination that is often made by identifying the points where production begins and where it ends. [45 IAC 2.2-5-1\(a\)](#); [45 IAC 2.2-5-4\(e\)](#); *Indianapolis Fruit*, 691 N.E.2d at 1383-84.

IC § 6-2.5-2-1 provides:

- (a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.
- (b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

IC § 6-2.5-3-2(a) provides:

An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

[IC 6-2.5-3-4](#) provides:

- (a) The storage, use, and consumption of tangible personal property in Indiana is exempt from the use tax if:
 - (1) the property was acquired in a retail transaction in Indiana and the state gross retail tax has been paid on the acquisition of that property; or
 - (2) the property was acquired in a transaction that is wholly or partially exempt from the state gross retail tax under any part of [IC 6-2.5-5](#), except [IC 6-2.5-5-24\(b\)](#), and the property is being used, stored, or consumed for the purpose for which it was exempted.
- (b) If a person issues a state gross retail or use tax exemption certificate for the acquisition of tangible personal property and subsequently uses, stores, or consumes that property for a nonexempt purpose, then the person shall pay the use tax.

[IC 6-2.5-5-1](#) provides:

Transactions involving animals, feed, seed, plants, fertilizer, insecticides, fungicides, and other tangible personal property are exempt from the state gross retail tax if:

- (1) the person acquiring the property acquires it for his direct use in the direct production of food and food ingredients or commodities for sale or for further use in the production of food and food ingredients or commodities for sale; and
- (2) the person acquiring the property is occupationally engaged in the production of food and food ingredients or commodities which he sells for human or animal consumption or uses for further food and food ingredient or commodity production.

IC § 6-2.5-5-2 provides:

- (a) Transactions involving agricultural machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for his direct use in the direct production, extraction, harvesting, or processing of agricultural commodities.
- (b) Transactions involving agricultural machinery or equipment are exempt from the state gross retail tax if:
 - (1) the person acquiring the property acquires it for use in conjunction with the production of food and food ingredients or commodities for sale;
 - (2) the person acquiring the property is occupationally engaged in the production of food or commodities which he sells for human or animal consumption or uses for further food and food ingredients or commodity production; and
 - (3) the machinery or equipment is designed for use in gathering, moving, or spreading animal waste.

[IC 6-2.5-3-4](#) provides:

- (a) The storage, use, and consumption of tangible personal property in Indiana is exempt from the use tax if:
 - (1) the property was acquired in a retail transaction in Indiana and the state gross retail tax has been paid on the acquisition of that property; or
 - (2) the property was acquired in a transaction that is wholly or partially exempt from the state gross retail tax under any part of [IC 6-2.5-5](#), except [IC 6-2.5-5-24\(b\)](#), and the property is being used, stored, or consumed for the purpose for which it was exempted.
- (b) If a person issues a state gross retail or use tax exemption certificate for the acquisition of tangible personal property and subsequently uses, stores, or consumes that property for a nonexempt purpose, then the person shall pay the use tax.

The exemption for agricultural production is further explained at [45 IAC 2.2-5-1\(a\)](#) states in relevant part:

Definitions. "Farmers" means only those persons occupationally engaged in producing food or agricultural commodities for sale or for further use in producing food or such commodities for sale. These terms are limited to those persons, partnerships, or corporations regularly engaged in the commercial production for sale of vegetables, fruits, crops, livestock, poultry, and other food or agricultural products. Only those persons, partnerships, or corporations whose intention it is to produce such food or commodities at a profit and not those persons who intend to engage in such production for pleasure or as a hobby qualify within this definition.

"Farming" means engaging in the commercial production of food or agricultural commodities as a farmer.

"To be directly used by the farmer in the direct production of food or agricultural commodities" requires that the property in question must have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces food or an agricultural commodity.

[45 IAC 2.2-5-4](#)(e) states:

The fact that an item is purchased for use on the farm does not necessarily make it exempt from sale [sic.] tax. It must be directly used by the farmer in the direct production of agricultural products. The property in question must have an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces agricultural products. The fact that a piece of equipment is convenient, necessary, or essential to farming is insufficient in itself to determine if it is used directly in direct production as required to be exempt.

There is no question that Taxpayer is a farmer engaged in the direct production of food or agricultural commodities and is entitled to claim the exemption for equipment directly involved in the direct production of that personal property. The issue is whether the hoop buildings are employed within Taxpayer's production process and therefore exempt from sales and use tax.

In its August 31, 2007 written protest, Taxpayer describes the use of the hoop buildings as follows:

The hoop buildings are used to transition the hay from the field to final sell. A salt is added to the hay in the drying process to increase the sweat process while the hay is in the hoop buildings. These buildings are especially designed to promote the sweating and drying process.

The above letter also references another written description of the process that was given to the Department's auditor. The description given to the auditor states:

The quality of hay is determined by the method of processing after baling. Hay goes through a sweat process within the first 7 to 10 days after being moved to the hoop buildings. The hoop buildings are open at both end[s] to generate ventilation. Barn salt, ventilation, and fans are used to encourage the hay's normal sweat process to "cure" the hay. After two weeks there is another heat cycle, this can take a number of weeks and a number of cycles until the hay is cured. This process is what produces the quality of hay and allows [Taxpayer] to produce the quantity needed for its production.

Holes are punched through the bales to allow the barn salt to penetrate [the bales].

A tarp roofing prevents the sun from bleaching the hay and allows the drying and breathing of the ventilation process.

The hay sets on pallets to provide more circulation and drainage. The floor is gravel and lime to draw away moisture. There is more drainage outside the hoop buildings, all for the purpose of pulling water away from the hoop building. Even the ground is worked in a manner to flow the water away from the buildings.

We are MAKING something happen. The hay sweats and cures. The hoop buildings are an essential part of the integrated process. A normal barn structure would burn down and has in the past.

(Emphasis in original).

Taxpayer also provided photographs of the hoop buildings in various stages of "construction." Taxpayer specifically wished the Department to note the "drip rails" and trench drains that surround the hoop building in some of the pictures. These, according to Taxpayer, help prevent the hay from getting wet.

Taxpayer attached materials that appear to be from a supplier of these buildings that describe some of the components of the buildings, their uses, advantages, etc. The buildings are referred to in the materials as "quick buildings." Among the uses of the buildings described in these materials is: warehousing, storage of farm machinery and construction equipment, truck and vehicle garages, sow gestation barns, swine finishing, *grain and hay storage*, as free-stall dairy and calf barns, field maintenance shops, and storage for litter and manure. The promotional materials also say that the buildings are designed for "high ammonia environment."

The fact that "something happens" while the hay is in the hoop buildings is not determinative of whether or not the buildings are exempt from use tax. The critical fact is whether the bales of hay are already in marketable form when they are introduced into the hoop buildings.

In *Indianapolis Fruit*, the court held that appellant taxpayer's equipment involved in the production of ripened bananas was entitled to the sales and use tax exemption. *Indianapolis Fruit*, 691 N.E.2d at 1386. The court found that appellant taxpayer's introduction of ethylene gas into the banana ripening process was "sufficient to constitute production." *Id.* at 1385. In contrast, the court held that appellant taxpayer's tomato ripening equipment was not entitled to the exemption because that particular ripening activity "was essentially passive in nature." *Id.* at 1386. The court summarized the distinction as follows: "With respect to the bananas, [taxpayer] actively induced the ripening; it did no such thing with respect to the tomatoes. In other words, the difference is that, with respect to the bananas, [taxpayer] made something happening; with respect to the tomatoes, [taxpayer] let something happen." In *Indianapolis Fruit*, the bananas would not ripen without the treatment they receive in the ripening booths. The ripening booths had "significant transformational effect" on the bananas. *Id.* at 1384.

On the other hand, the court found that while the tomatoes that were placed in "a tightly controlled environment" underwent "substantial physical and chemical change" while ripening, the transformation that took

place was merely incidental to proper storage. *Id.* at 1385-86. The tomatoes were not "in production" so to speak. The bales of hay are like the tomatoes in *Indianapolis Fruit*. The physical and chemical changes that take place while curing are incidental to proper storage.

Graham Creek Farms v. Ind. Dep't of State Revenue, 819 N.E.2d 151 (Ind. Tax Ct. 2004) dealt with the agricultural exemption as it related to the taxpayer's use of tobacco barns in its tobacco production process. There, the taxpayer cut down mature tobacco stalks and attached them to long sticks which were then spread out on specially designed rails and dried for a couple of months. The tobacco that went into the building was not in marketable condition. It was only after a properly controlled drying process that the tobacco became marketable. The court held in favor of the taxpayer's claim for exemption of the tobacco barn from use tax:

The evidence demonstrates that in the tobacco drying process, the proper circulation of air is essential to avoid "house burn." Marketable tobacco is not produced until an eighty-pound stick of tobacco stalks is dried and essentially reduced to one and a half pounds of marketable tobacco. Clearly, the drying process has a direct effect on transforming unmarketable tobacco stalks into marketable tobacco.

Id. at 159.

In this case, the bales of hay that are placed in the hoop buildings are already in marketable form, therefore whatever happens to the bales of hay when they are inside the hoop buildings is outside of the integrated production process.

Lastly, Taxpayer, also points to [45 IAC 2.2-5-3\(e\)\(2\)](#) in an attachment to its August 31, 2007 protest letter, in support of its claim that the hoop buildings qualify for the exemption.

[45 IAC 2.2-5-3\(e\)](#) states:

Exempt Purchases:

(1) Heating, cooling, and ventilation equipment for agricultural production is exempt when it is directly used in the direct agricultural production process provided that such equipment is directly used in the production process, i.e. has an immediate effect on the article being produced. Property has an immediate effect on the article being produced if it is an essential and integral part of an integrated process which produces food or agricultural commodities.

(2) Confinement buildings that confine animals in order to (1) maintain physical integrity of the product, (2) create and control the environment in order to facilitate production, and (3) function in conjunction with exempt machinery such as fans, thermostats, vents, cooling and heating systems, are exempt. In addition, in order to qualify for the exemption, the confinement building must serve a breeding, gestation, farrowing, and nursing or finishing function. For purposes of this exemption, confinement involves holding the animal within the confines of the building or an attached confined porch area.

[45 IAC 2.2-5-3\(e\)\(2\)](#) deals with *confinement buildings that confine animals*. Taxpayer's hoop buildings are not confinement buildings for animals. Also, the "finishing function" referred to in the statute is a term of art used by farmers who raise animals for human consumption, and does not relate to the type of process referred to in Taxpayer's description of its hay drying process. Furthermore, the animals that are confined in the building are clearly not in marketable form when they are placed in the building.

Taxpayer produces a significant number of bales of hay, cutting and baling hay at times when its moisture content may be higher than is optimal for storage. Therefore this method of storage is necessary for its operation to reduce fire hazards, protect the hay from the elements, allow proper drainage of water, and minimize the formation of mold and mildew. Placement in the hoop buildings is simply an effective way for Taxpayer to store the bales of hay until they are sold to its customers.

Given the above, the hoop buildings Taxpayer uses to cure and store his bales of hay do not qualify for exemption from use tax. Since Taxpayer did not present any evidence that he had paid sales tax when he purchased the hoop buildings out of state, and the Department's audit found no such evidence, Taxpayer's purchase of the hoop buildings is subject to use tax.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Ten Percent Negligence Penalty.

DISCUSSION

The Taxpayer also protested the imposition of the ten percent negligence penalty pursuant to IC § 6-8.1-10-2.1. Indiana Regulation [45 IAC 15-11-2\(b\)](#) clarifies the standard for the imposition of the negligence penalty as follows:

Negligence, on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The standard for waiving the negligence penalty is given at [45 IAC 15-11-2\(c\)](#) as follows:

The department shall waive the negligence penalty imposed under [IC 6-8.1-10-1](#) if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

- (1) the nature of the tax involved;
- (2) judicial precedents set by Indiana courts;
- (3) judicial precedents established in jurisdictions outside Indiana;
- (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc;
- (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayer has affirmatively established, as required by [45 IAC 15-11-2\(c\)](#), that its failure to pay sales tax on the transactions relating to the hoop buildings was due to reasonable cause and not due to negligence.

FINDING

Taxpayer's protest is sustained.

CONCLUSION

Taxpayer's use of its hoop buildings does not qualify for exemption from use tax.
The ten-percent negligence penalty is waived.

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